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In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

JOINT BRIEF IN OPPOSITION TO THE UNITED STATES OF AMERICA'S PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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Question Presented

Whether a bankruptcy court, in balancing the interests of all creditors, may require the Internal Revenue Service to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability.

List of Parties

The parties to the proceedings below were the United States of America, petitioner, and William A. Browner, Trustee of the ERCO Liquidation Trust, and Robert Cataldo, as Chapter 11 Trustee of Newport Offshore, Ltd., respondents.[1]

[1] Energy Resources Co., Inc. and Newport Offshore, Ltd. were erroneously named as parties in the caption of the decision below.

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The citations to the opinions and judgments delivered below, the statement of the grounds on which the jurisdiction of this Court is invoked, the recitation of the statutes applicable to

these cases and the statement of the case as presented in the United States of America's Petition for Writs of Certiorari ("Petition") are satisfactory to the respondents and need not be restated. Furthermore, we adopt the Petition's appendix ("App.") for purposes of any citations herein.

Reasons for Denying the Writ

The Petitioner has stated that "[t]he court of appeals has erroneously decided an important . . . question of federal law, in direct conflict with the decisions of other courts of appeals." Petition at 11. The decision below is not erroneous, is not in direct conflict with the decisions of other courts and does not as a practical matter decide an important question.

I. The First Circuit's Decision Does Not Produce a Direct Conflict Among the Circuit Courts such as to Warrant Grant of Certiorari.

The Petitioner is incorrect in contending that the First Circuit acknowledged that its decision "directly conflicts with the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987)." Petition at 12. What the First Circuit did acknowledge was that upon the application of the test announced by it to the facts of the cases before it, its result was not consistent with the result reached by the Third Circuit in *In re Ribs-R-Us* (App. 4a). The Third Circuit had announced a *per se* rule that payments to the Internal Revenue Service ("IRS") were "involuntary" and that such payments could not be designated by the Chapter 11 debtor or the bankruptcy court to the debtor's trust fund liabilities. 828 F.2d at 204. The First Circuit agreed

with the Third Circuit in accepting the IRS's view that "payments made pursuant to a Chapter 11 plan are 'involuntary' for purposes of its [IRS's] own rules" (App. 12a) and rejected the argument proffered by respondents that all such payments are *per se* "voluntary." The First Circuit, however, in finding that a bankruptcy court may nevertheless order the IRS to apply a payment in a way that runs counter to its own internal policies, fashioned the following *case by case* test to determine under what circumstances tax payments may be allocated:

> ". . . upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, i.e., increased likelihood of payment to creditors who might otherwise lose their money?" (App. 21a).

Thus, not only did the First Circuit not establish a *per se* rule at odds with the Third Circuit, but it offered a discretionary test which, had that court before it the same facts that were before the Third, Sixth and Ninth Circuits respectively in *In re Ribs-R-Us, supra*; *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988); and *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987), it might well have come to precisely the same result those courts arrived at. Perhaps more importantly, in cases like this one, certiorari should be granted only where there is "a real and embarrassing conflict of opinion and authority between the Circuit Courts of Appeals." *N.L.R.B.* v. *Pittsburgh S.S. Co.*, 340 U.S. 498, 502 (1951). That standard has not been met; until the bankruptcy courts within the First Circuit are afforded the opportunity of applying the above test, there is no way of knowing whether or not

(i) it will be very narrowly construed, (ii) it will have a significant impact, or (iii) it will influence courts outside the First Circuit.

II. The Question Presented is not of Practical Importance to the Administration of the Bankruptcy or the Tax Laws.

A. *The IRS Will Continue to have Ample Opportunities to Collect Unpaid Trust Fund Taxes from Responsible Persons and Minimize Any Risk to the Treasury.*

In order to prevent a loss to the treasury, Congress, through Section 6672 of the Internal Revenue Code, provided that if the persons in a corporation responsible for collecting, accounting for and paying over such "trust fund" taxes to the government willfully fail to do so, they each become personally liable for a "penalty" in the full amount of the unpaid trust fund taxes. The Petitioner is thus wrong when it argues that the First Circuit's decision "allows responsible persons to use the corporate Chapter 11 proceedings as a shield to protect themselves from Section 6672." Petition at 18. As the Court specifically noted:

> "And, so long as there is a 'trust fund' tax debt outstanding, nothing, including our opinion today, legally restrains the IRS from attempting to collect 'trust fund' taxes from 'responsible' individuals. *See In re LaSalle Rolling Mills*, 832 F.2d 390 (7th Cir. 1987) (Anti-injunction Act prohibits courts from restraining IRS from collecting 'trust fund' taxes from individuals under § 6672); *A to Z Welding & Manufacturing Co.* v. *United States*, 803 F.2d 932 (8th Cir. 198[6]) (same); *Huckabee Auto Co.*, [783 F.2d 1546 (11th Cir. 1986)]."

(App. 20a).

Under Section 7421 of the Internal Revenue Code, the so-called "Anti-Injunction Act," no court has the right to restrain "the assessment or collection of any tax." Thus, there is no "shield" that protects any responsible person from Section 6672 and none was asserted by the responsible persons affected by the decisions in the cases at bar. The three court of appeals cases cited in the above quotation from the First Circuit's opinion all represent attempts in corporate Chapter 11 cases to enjoin the IRS from pursuing collection of trust fund taxes from officers or shareholders of a Chapter 11 corporation while the corporation sought to reorganize and pay those taxes itself under a plan of reorganization. In each case the court of appeals held that the Anti-Injunction Act prohibited any court from restraining the collection of trust fund taxes under Section 6672, whether or not those same taxes might ultimately have to be paid in full by the corporate debtor in its Chapter 11 case. In light, therefore, of the government's ability to pursue responsible persons before, during and after a successful Chapter 11 case, the government's interest might be jeapordized by the decision below, if at all, only if the IRS fails to exercise the remedies indisputably available to it.

B. *A Chapter 11 Plan Must Be Found Feasible Prior to its Confirmation.*

The precise issue presented by this case can only arise after the bankruptcy court has entered an order confirming a reorganization plan. 11 U.S.C. §§ 1129, 1141(a). Before such confirmation, thirteen specific requirements, as set forth in 11 U.S.C.

§ 1129(a), must be met. Among those are requirements that (i) the plan must provide for the full payment of priority taxes within six years of assessment, 11 U.S.C. § 1129(a)(9)(C), and (ii) the plan must be feasible, i.e., that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan. . . ." 11 U.S.C. § 1129(a)(11). It is and should be difficult to meet this feasibility requirement, as is demonstrated in the following cases, among many, where the courts were not persuaded and refused to confirm the proposed plan. *In re Clarkson*, 767 F.2d 417, 419-20 (8th Cir. 1985) and *In re Merrimack Valley Oil Co., Inc.*, 32 Bankr. 485, 487-91 (Bankr., D. Mass. 1983). Accordingly, the IRS has in all cases full opportunity to press for liquidation of the debtor, and thus payment of its priority taxes forthwith, where it believes and can show that no plan is "feasible." Where, alternatively, the bankruptcy court has determined that the plan proponent has met its burden of proof, the court has effectively made a finding promoting administration of the tax laws and maximizing the likelihood of payment.

C. *Application of the First Circuit's Test May Not Result in Allocation of Tax Payments.*

Clearly, the First Circuit's test (App. 21a) is far more restrictive than the *per se* voluntary ruling urged by respondents below. Accordingly, in those few instances where the plan proponent in a successful Chapter 11 case requests the bankruptcy court to compel the allocation of tax payments, the Petitioner is free simply to resist that request by arguing on the merits that the compulsory allocation will not in fact meaningfully contribute to the reorganization and/or the "increased likelihood of payment to creditors who might otherwise lose their money." (App. 21a).

D. *The United States Overstated the Alleged Fiscal Impact of the First Circuit's decision.*

On page 21, notes 8 and 9 of the Petition, the Petitioner cited an unidentified "report" of the Administrative Office of United States Courts that 90% of Chapter 11 reorganizations fail and an unidentified and unsupported estimate that up to $34 million could be lost if designations are permitted "routinely." These references are *not* in the record below, must be ignored and are in any event seriously misleading. Clearly, if certiorari is not granted, any adverse fiscal impact will be limited to those few future cases, if any, where the First Circuit's test is applied to allow allocation and then only where the plan ultimately fails before payment in full and the responsible persons are not pursued successfully either initially or after failure of the plan. Equally clearly the cited "report" referenced in *In re Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 382 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988), is irrelevant to the question presented here because it appears to stand only for the proposition that 90% of cases filed under Chapter 11 do not result in confirmed, non-liquidation plans, and *not* the proposition that 90% of confirmed reorganizations fail before payments are completed.

III. The First Circuit's Decision Is Correct.

The decision of the court of appeals, "that the law does authorize a bankruptcy court to order the IRS to allocate [tax payments under a confirmed reorganization plan] . . . to a taxpayer's 'trust fund' liability first" (App. 6a), is correct. This authority derives from the bankruptcy court's broad equitable powers to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the

Bankruptcy Code, as codified in 11 U.S.C. § 105(a). The court of appeals recognized that the bankruptcy court may exercise this equitable power to designate the application of tax payments only if the "court reasonably concludes that this allocation will likely increase the reorganization plan's chances for success." (App. 6a-7a). Only in this manner can the potentially conflicting policies of the Bankruptcy Code, favoring rehabilitation of the debtor in the interest of all creditors, and of the Internal Revenue Code, favoring collection of tax revenue above all, be reconciled.

The Petitioner's position, that the IRS may apply the debtor's tax payments as it (the IRS) sees fit, stems from its assertion that these payments are "involuntary," a characterization on which the case law is divided but that the court of appeals accepted for the limited purposes of the IRS's application of its own rule. The distinction between this treatment of voluntary and involuntary payments, in turn, derives originally from non-tax cases applying common law principles to the effect that a debtor may not designate how a payment is to be applied where the payment is seized from him by distraint or court action akin to distraint. *Amos* v. *Commissioner*, 47 T.C. 65, 68-69 (1966).

However, under this common law concept, even though a debtor cannot designate the application of an "involuntary" payment, it does not follow automatically that the creditor can unilaterally make that decision. A number of courts have held that when a court orders a payment, the court itself may prescribe the manner in which the payment must be applied, despite the contrary wishes of the creditor. See e.g. *First National City Bank* v. *Kline*, 439 F. Supp. 726, 729 (S.D.N.Y 1977) (stating that "where . . . moneys are repaid under judicial order, the court has exclusive authority to apply the funds, and its application must be structured as 'equity and justice require' "); *United States* v. *Transamerica Insurance Company*, 357 F. Supp. 743, 748 (E.D. Va. 1973) (stating that the court must "follow basic principles of equity, seeking to protect the rights and priorities of all the parties"); *Commercial Credit Corporation* v. *Schwartz*, 130 F. Supp. 524, 530-31 (E.D.Ark. 1955) (federal district court exercised its equitable powers to set aside IRS allocation of involuntary payment because allocation was unfair to other creditors).

The Petitioner can point to no statute or regulation requiring or even authorizing the IRS to apply a debtor's tax payments under a confirmed reorganization plan in any particular way. There is none. Indeed, a recent legislative effort intended to afford the IRS the power it asserts here failed. (App. 20a). Instead, the Petitioner points to "[t]he IRS's long standing policy" (Petition at 15) embodied in three revenue rulings. Rev. Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43, superseding Rev. Rul. 58-239, 1953-1 C.B. 94. But, none of these rulings involves a bankruptcy reorganization or any other judicial proceeding in which a court has ordered the application of the funds after considering the interests of the debtor, the IRS, and other creditors. The cited rulings merely state the IRS's position that it will honor a taxpayer's designation of payments that it makes voluntarily. They do not address at all the issue of whether payments under a confirmed reorganization plan are voluntary or involuntary or how such payments would be treated if they were held to be involuntary.

On that issue there is only an internal IRS policy contained in the Internal Revenue Manual ("I.R.M."). See Internal Revenue Manual, Part V, 57(13)4.3. However, "[b]ecause '[t]heir purpose is to govern the internal affairs of the [IRS],' the procedures of the IRS [contained in the I.R.M.] do not have the force or effect of law." *Vallone* v. *Commissioner*, 88 T.C. 794, 807 (1987), and cases cited therein. Indeed, even with respect to the IRS itself, "the policies and guidelines set forth

in the Internal Revenue Manual are directory, not mandatory." *Timmerman et al.* v. *Swenson et al.*, 79-2 U.S. Tax. Cas. (CCH) ¶9588 (D. Minn. 1979), and cases cited therein.

By contrast, Congress has expressly granted the bankruptcy court authority under 11 U.S.C. § 105(a) "to issue any order . . . that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Surely a mere internal policy of the IRS, one that is not required by any statute or even incorporated in a regulation, should not be accorded such weight as to divest the bankruptcy court of its power to prescribe the application of tax payments under a confirmed Chapter 11 reorganization plan by such an appropriate order.

Conclusion

The petition for writs of certiorari should be denied.

Respectfully submitted,

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